

Tax laws and commute-related expenses: *identifying the tax advantages*

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Introduction

Under specific conditions established by the IRS, pre-tax income can be used by employees for commute-related expenses including transit passes. The following pages address this topic and also touch upon other commute-related tax issues, such as tax-free fringe benefits, that provide advantages for both the employer and the employee.

This material has been developed for King County Metro by a team of tax advisors and represents their advice regarding these issues as of the date printed at the bottom of this page. Please use this information as a general guide for decision-making. Your individual situation may differ from the ones presented and, because IRS regulations can change, employers and employees are encouraged to consult with a private tax professional regarding these matters.

An overview of pre-tax laws relating to transportation expenses

The net effect of using pre-tax income for transportation expenses—for both the employer and the employee—is lower payroll taxes.

The IRS allows a few specific items, including transit passes, to be paid for by an employee using pre-tax income. This has the effect of reducing the employee's wage base upon which payroll taxes are calculated while he or she also takes advantage of the transportation benefit.

It is the employer's responsibility to maintain records of the transit expense. In the company payroll system, the employee's share of the cost of the item is deducted directly from his or her salary before payroll taxes are calculated.

What is “pre-tax income”?

Pre-tax income is the employee's gross salary prior to calculating FICA and federal withholding. Qualified items purchased by the employee with pre-tax income are deducted right off the top of the salary prior to payroll tax calculations—i.e., no payroll taxes are paid on an amount equal to the cost of these items. *As of tax year 2004, the IRS allows individuals to pay for transit passes, up to \$100 per month, with pre-tax income.*

What is the difference between “pre-tax income” and a “tax-free fringe benefit”?

Don't confuse the concept of **pre-tax income** with **tax-free fringe benefits**, which are a completely separate issue.

To understand the difference between **pre-tax income** and **tax-free fringe benefits** remember this:

- ◆ **Pre-tax income** applies only when *the employee has paid* for the qualified expense.
- ◆ **A tax-free fringe benefit** applies only when *the employer has paid* for the qualified expense.

To help employees defray the costs of qualified commuting expenses, the IRS allows employers to provide up to \$100 per month (2004 tax year) to an employee as a **tax-free fringe benefit**. This means an employer can:

1. give an employee up to \$100 in transit passes or tickets each month
2. sell transit passes or tickets to an employee at up to a \$100 discount

To help defray the cost of **parking**, IRS regulations also allow employers to provide up to \$195 per month (2004 tax year) as a tax-free fringe benefit. Contact your tax advisor for further information. A brief discussion of how this regulation relates to employer-provided carpool parking appears on page 13, question 1.



Using pre-tax income for transit (bus, rail, ferry, vanpool)

EXAMPLE: Using pre-tax income to buy a transit pass

Mary, an employee of ABC Company, has a salary of \$3,500 per month. ABC Company decides to allow pre-tax income for employees to purchase transit passes. Under IRS regulations, pre-tax income of up to \$100 per month per employee can be used to purchase bus, rail, ferry or vanpool fares. The transit pass Mary wishes to purchase costs \$72 per month, which falls within the IRS allowed amount. (NOTE: For a transit pass costing more than \$100 per month, the employee can use only \$100 as pre-tax income. The cost in excess of \$100 is taxable.)

Mary's taxable income is reduced by \$72 per month using pre-tax dollars to purchase her transit pass. Therefore, she saves on FICA (i.e., Social Security and Medicare) and federal income taxes. Because an employer must match the amount of FICA taxes deducted from an employee's paycheck, ABC also realizes a savings in FICA taxes. (NOTE: Employers are not responsible for matching any part of their employees' federal income withholding and, therefore, have no savings for federal withholding when an employee's taxable pay is reduced.)

It is important to remember that pre-tax income to purchase Mary's transit pass only applies to that portion of the pass for which she pays. For example, if ABC provides a \$30 pass subsidy for its employees, any *pre-tax* advantages for ABC Company or Mary apply only to the \$42 portion (of the \$72 total cost) that she pays for out of her own income. However, the \$30 subsidy is *non-taxable* for Mary because it falls under the \$100 IRS cap for allowable transportation benefits—and it is also deductible as a business expense for ABC.

Pre-tax income advantages are also applicable to vanpool fares when the vanpool vehicle is provided by public transit operators like King County Metro. ***Employer-provided vanpool vehicles*** must meet specific IRS requirements in order to qualify for pre-tax advantages. See page 11, question 8, for a brief discussion of this issue, and contact your tax advisor for more information.

Tax advantages for ABC Company (re payroll taxes paid on Mary)

Before the option to use pre-tax income was offered, Mary's transaction to purchase her bus pass was independent of receiving her wages. The taxes that were paid on Mary's wages by ABC Company are shown in column A below.

After Mary is able to buy her bus pass through ABC Company using pre-tax dollars, her taxable salary is decreased by \$72 per month (i.e., the cost of the pass), and the payroll taxes paid by ABC are calculated on \$3,428 per month as shown in column B below.

**Monthly Tax Savings for ABC Company on Mary's Wages
Using Pre-Tax Income for a Transit Pass**

	A: Before option of pre-tax income	B: Using pre-tax income	C: Tax savings for ABC Co. using pre-tax income	
Taxable income	\$ 3,500.00	\$ 3,500.00 transit pass = <u>(72.00)</u> \$ 3,428.00		
FICA taxes @ 7.65% Federal withholding*	267.75 <u>not applicable</u>	186.43 <u>not applicable</u>	5.51 <u>not applicable</u>	<u>Annual tax Savings</u>
Total taxes	\$ 267.75	\$ 262.24	\$ 5.51	x 12 = \$66.12

* For purposes of this example, Mary is married and her husband earns \$36,000 a year. They have no children, do not own their own home, and have no other sources of income or deductions.

As column C above indicates, ABC Company has now saved \$5.51 per month, or \$66.12 annually, on its payroll taxes simply because it allows Mary to buy the transit pass using pre-tax dollars.

To state the obvious, the tax advantages to ABC Company increase in proportion to the number of employees using pre-tax income to purchase their transit passes. **For example, if 100 employees adopt this option, ABC then saves \$551 per month in FICA taxes, the equivalent of \$6,612 in savings for the year.**

Tax advantages for Mary (the employee)

Before the option to use pre-tax income was offered, Mary's transaction to purchase her transit pass was independent of receiving her wages. She paid the monthly payroll taxes shown in column A below.

After Mary is able to buy the bus pass through her employer using pre-tax dollars, her taxable salary is decreased by \$72 per month (i.e., the cost of the pass), and her payroll taxes are calculated on \$3,428 per month as shown in column B below.

Monthly Tax Savings for Mary using Pre-Tax Income for a Transit Pass

	A: Before option of pre-tax income	B: Using pre-tax Income	C: Tax savings for Mary using pre-tax income
Taxable income	\$ 3,500.00	\$ 3,500.00 transit pass = <u>(72.00)</u> \$ 3,428.00	
FICA taxes @ 7.65%	267.75	262.24	5.51
Federal withholding*	<u>457.00</u>	<u>439.00</u>	<u>18.00</u>
Total taxes	\$ 724.75	\$ 701.24	\$ 23.51
Transit pass	(72.00)		
Net or take home	\$2,703.25	\$2,726.76	

* For purposes of this example, Mary is married and her husband earns \$36,000 a year. They have no children, do not own their own home, and have no other sources of income or deductions.

As the table shows, Mary now saves \$5.51 per month in FICA taxes (i.e., Social Security and Medicare) and \$18.00 per month in federal income tax for a total savings of \$23.51.

In effect, with the tax savings Mary has realized, her \$72 transit pass now costs her just \$49 a month (i.e., \$72 - \$23.51 = \$48.49). Effectively, she has received a "pay raise" from \$2,703.25 to \$2,726.76 per month.



Employee parking as a tax-free fringe benefit—and the parking “cash out” option

The IRS allows an employer to provide a tax-free benefit of up to \$195 per month per employee for qualified parking expenses (2004 tax year). As with the \$100 cap for transit passes as tax-free fringe benefits (see shaded box on page 2), this means that the employer can pay parking up to \$195 per month with no impact to the employee’s paycheck or taxes. This \$195 is in addition to other transportation benefits that might be offered.

Regarding Parking “Cash Out”

A parking cash out option involves offering cash to an employee instead of providing that employee with a parking space. For example, the employee could opt to give up his or her parking space in exchange for \$100 in cash from his or her employer. The cash out amount does not have to be the same dollar amount as the actual cost of parking.

Note that a parking subsidy is very different from a cash out transaction. Under a subsidy, the employer pays, at least in part, for the employee parking benefit. On the other hand, cash out is additional salary. However, in either case, they are a cost to the company of doing business—i.e., they are business expenses that are deductible for tax purposes.

While the cash out option is a business deduction for the employer, it also represents an increase in FICA taxes for the company. The employee receives the advantage of cash-in-hand, but must pay an increase in both FICA and federal income taxes.

EXAMPLE: Parking “Cash Out”

Tom, another employee of ABC Company, happens to have that same salary of \$3,500 per month. ABC Company decides to provide a parking cash out option of \$100 per month for its employees.

Tax implications for ABC Company (re payroll taxes paid on Tom)

Monthly taxes paid by ABC Company on Tom's income prior to the company's decision to provide cash out are shown in column A below. After the company provides cash out to Tom, his taxable salary is increased by \$100, and the payroll taxes paid by ABC are calculated on \$2,600 per month as shown in column B below.

Monthly Tax Costs for ABC Company on Tom's Wages with \$100 "Cash Out"

	A: Before "cash out"	B: Using "cash out"	C: Tax increase for ABC Co. using "cash out"
Taxable income	\$ 3,500.00	\$ 3,500.00 "cash out" = <u>100.00</u> \$ 3,600.00	
FICA taxes @ 7.65%	267.75	275.40	7.65
Federal withholding*	<u>not applicable</u>	<u>not applicable</u>	<u>not applicable</u>
Total taxes	\$ 267.75	\$ 275.40	\$ 7.65

* For purposes of this example, Tom is married and his wife earns \$36,000 a year. They have no children, do not own their own home, and have no other sources of income or deductions.

As column C indicates, ABC Company now pays an additional \$7.65 per month on its payroll taxes for Tom due to its cash out program. **For 100 employees, the additional taxes would amount to \$765 per month or \$9,180 per year.** The employer can compare this additional cost with the cost of leasing or purchasing parking spaces for employees.

Tax implications for Tom (the employee)

Monthly taxes paid by Tom prior to the cash out option are shown in column A below. After ABC provides Tom with cash out, his taxable income is increased by \$100, and the payroll taxes he pays are calculated on \$3,600 per month as shown in column B below.

Monthly Tax Costs for Tom with \$100 “Cash Out”

	A: Before “cash out”	B: Using “cash out”	C: Tax increase for Tom with “cash out”
Taxable income	\$ 3,500.00	\$ 3,500.00 “cash out” = <u>100.00</u> \$ 3,600.00	
FICA taxes @ 7.65%	267.75	275.40	7.65
Federal withholding*	<u>457.00</u>	<u>482.00</u>	<u>25.00</u>
Total taxes	\$ 724.75	\$ 757.40	\$ 32.65

* For purposes of this example, Tom is married and his wife earns \$36,000 a year. They have no children, do not own their own home, and have no other sources of income or deductions.

When the additional \$32.65 in taxes (see column C above) is subtracted, Tom actually takes home \$67.35 per month of the \$100 cash out benefit (i.e., \$100 - \$32.65 = \$67.35), which calculates to \$808.20 in additional take home pay for the year. Tom now has his parking cash out money in hand and can make choices about how he gets to work. For example, he can join a carpool, ride the bus, ride his bicycle or walk.



Using pre-tax income for carpooling, bicycling or walking incentives

At this time, there is no IRS mechanism to allow pre-tax dollars to be used to provide financial incentives to employees to encourage them to carpool, bicycle or walk to work.

At best, employees who commute in a carpool can use pre-tax dollars for parking if they meet certain IRS requirements. Contact your tax advisor for further information.



Frequently asked tax questions about transit—and the answers

The following questions are often asked regarding tax issues relating to commuting by transit, i.e. bus, vanpool, ferry or rail.

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About transit subsidies

1. Is a transit subsidy a business expense? How does an employer account for it?

A “subsidy” is the portion that the employer pays for a benefit. Transit subsidies are business expenses for the employer, which are deductible for tax purposes.

2. If the employer exceeds the \$100 per month per employee limit allowed by the IRS as a tax-free fringe benefit, is the subsidy tax-exempt?

The amount over the \$100 is always considered taxable employee income.

3. If an employee receives multiple commute subsidies because their employer’s transportation benefits program is “multi-modal” (for example, incentives for bus and carpool commutes) does that individual get taxed on all such benefits? Or, if he or she is mostly a transit rider, can they waive tax responsibility on the carpool benefit they receive?

This is a gray area currently not addressed by the IRS. However, it is commonly assumed that the carpool benefit cannot be waived and is considered taxable income to the employee. Therefore, the costs of the carpool benefit must be subtracted from the overall cost of the commute subsidies for tax purposes. The safest course of action, of course, would be to *not* include a carpool benefit in a package of transit subsidies, but to itemize it as a separate accounting item.

4. If the employer reimburses an employee for all or part of the cost of a transit pass, does the reimbursed amount qualify as a tax-free fringe benefit?

Yes, but under current IRS regulations, a transit reimbursement paid in dollars in an area where *transit vouchers* are available does not qualify as tax-free fringe benefit. (King County is currently interpreted as one of those areas because Commuter Bonus vouchers are available.) However, it does qualify as a tax-free fringe benefit if the employer gives an employee up to \$100 in *transit passes or tickets* each month—or sells transit passes, tickets or vouchers to the employee at up to a \$100 discount.

5. ***Our company offers FlexPass (i.e., a transit pass program that allows employers to purchase a deeply discounted transit pass if they buy passes for all employees). In terms of the benefit to the employer, is the benefit divided by the number of FlexPasses purchased (which is also the number of employees eligible) or by the number of employees who actually pick the passes up?***

This benefit is based on the number of passes purchased, as the employer cannot be expected to police who is or is not using the pass. However, it seems best for tax purposes to use a distribution mechanism which ensures that every employee actually receives the pass. (This has the added advantage of increasing the likelihood that employees will use their FlexPasses.) An example of a good distribution method would be to distribute the FlexPasses to all employees with their paychecks.

6. ***For employers who provide FlexPasses and pay transit agencies annually, can the tax-free fringe benefits to employees be divided over the twelve months or are you limited to the month in which you made payment?***

The IRS is currently silent on the specifics of this matter. However, the intent of the law is to limit the benefits in any single month to \$100 or less per employee whether the employer provides a monthly, quarterly or annual transit pass. A company policy, which specifically addresses this issue, could be sufficient. For example, the company could establish a written policy that the employee must return the quarterly or annual transit pass if he or she quits during the year or the remaining value of the transit pass will become taxable income.

7. ***Are there Washington State tax savings for an employer providing transit subsidies?***

There may be. Please contact the Washington State Department of Revenue for information about the B&O tax credit.

8. *For tax purposes, how does the IRS define a “vanpool”?*

At this time, vanpool vehicles provided by King County Metro automatically meet the IRS definition of a vanpool. If an employer wishes to provide its own vanpool vehicle for employee commute purposes, it must meet the following IRS requirements: Employees are “vanpooling” if their vehicle can hold at least 6 passengers plus a driver. Any vehicle used which is smaller is considered to be a carpool and therefore carries with it different tax implications. In addition, at least 80% of the van’s use must be for transporting employees to and from work, and at least half of the seating capacity must be used by employees (excluding the driver).

9. *How much is each vanpool trip valued for calculation of the \$100 per month amount allowed by the IRS as a tax-free fringe benefit?*

If King County Metro provides the vanpool vehicle, the value is the actual amount of the subsidy provided to the employee by the employer up to \$100 per month. If the employer provides the vanpool vehicle, and meets all of the requirements listed in answer 8 above, the IRS commuting valuation rule values each one-way trip at a flat rate of \$1.50. For example, if the employee commutes in the vanpool 18 days during a given month, this is valued at \$54 (i.e., $\$1.50 \times 2 \text{ one-way trips per day} \times 18 \text{ days} = \54). Because the employee is under the \$100 per month cap for transit subsidies, the entire amount is excludable from taxable income, and there is no impact on salary or payroll taxes.

About using pre-tax income for transit

10. *What are the tax implications of an employer allowing employees to use pre-tax dollars to buy transit passes?*

To the employer, the tax implications are that there is a decrease in FICA taxes, but there is no business deduction for the cost of the bus pass paid for by the employee. There is also a decrease in FUTA taxes for the employer (Federal Unemployment Tax Act) for certain employees.

To the employee, the tax implications are a decrease in FICA taxes and federal income tax. See pages 2 – 5.

[In the State of Washington, there are generally no savings on Employment Security or Labor and Industries taxes.]

11. What are the tax implications of an employee co-pay (i.e., the impact on both the employer and employee) for a transit benefit?

Impact on employer: When the employer offers the pre-tax option to employees, there is a reduction in matching FICA taxes for the portion of the pass for which the employee pays. The amount the employer pays to purchase the pass is considered a tax deductible business expense.

Impact on employee: If the employer offers a pre-tax option, there is a reduction for the employee in payroll taxes (i.e., FICA and federal income tax) on the amount the employee pays for the pass. Any amount the company pays toward the purchase of the pass, up to the \$100 benefit allowed by the IRS, is a tax-free fringe benefit.

12. When an employer allows an employee to use pre-tax income to purchase a bus, vanpool, ferry or rail pass, the employer can handle the fare media (i.e., the passes, tickets or vouchers) or the employee can purchase the media and get reimbursed. Do either of these methods impact the tax-exempt status of the benefit?

When the employer handles the fare media and supplies the pass, tickets or vouchers to the employee, the transaction qualifies as pre-tax income up to the \$100 per month cap. However, under current IRS regulations, a transit reimbursement paid in dollars in an area where *transit vouchers* are available does not qualify as tax-free income. (King County is currently interpreted as one of those areas because Commuter Bonus vouchers are available.)

13. When an employee uses pre-tax dollars to pay for transit, where does the reduction in income appear on the W-2?

Pre-tax dollars used to pay for transit are treated as a reduction in taxable income. The amount appears as a reduction in boxes 1, 3 and 5. It may also be memoed on line 14.

Frequently asked tax questions about financial incentives for carpooling, bicycling and walking—and the answers

The following questions are often asked regarding the tax impacts of various payment arrangements to encourage employees to commute by carpooling, walking or bicycling, instead of driving alone.

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About financial incentives for carpooling, bicycling and walking

1. Are financial incentives taxable when paid or given to employees to encourage carpooling, walking and bicycling?

Yes, they should be treated as income to the employee and taxed accordingly. The only part of the financial incentives for carpooling, walking or bicycling that has the potential *not* to be taxable is carpool parking. The employer may pay for a parking space for a carpool, and this benefit is non-taxable to the employee up to \$195 per month. However, the benefit must be “assigned” to one member of the carpool (e.g., the driver, if there is an assigned driver, or a *designated* carpool member if there is no assigned driver). If the amount of the parking exceeds \$195 per month, the balance becomes a taxable benefit to that employee.

2. Who must track and report (to the IRS) information on employee subsidies or incentives?

It is always the employer’s responsibility.

3. How much record keeping and reporting is required for financial incentives to carpool, walk or ride a bicycle to work?

For carpool parking, record keeping is of the cost of the parking space and a written record regarding the people who are in the carpool. For all other subsidies relating to carpools, walking or bicycling, the money paid is additional salary and all rules applying to salary record keeping apply.

- 4. *What are the employee tax impacts of third-party payments for subsidies—for example, “matches” or “partnerships” where a party, other than the employer, provides part of the subsidy (e.g. King County, a TMA or a social service agency)?***

Taxable employee benefits are only a consideration when there is an employer-employee relationship. If the third party gives the payment directly to the *individual commuter*, there is no employer-employee relationship, and therefore no related employee tax issues. If a third party pays the subsidy to an employer, and then the employer gives the subsidy to the employee, there are tax consequences, as the benefit is between the employer and the employee.

- 5. *Is there a point at which the amount of an incentive is so small that it does not need to be accounted for or reported as income?***

The employer must track all incentives in order to count them as business expenses. However, very small incentives (known as “de minimis fringe”) do not have to be reported as income to the employee.

- 6. *What are the tax impacts of a financial incentive provided by an employer as an HOV contest prize?***

If the amount or value is over the de minimis fringe cap of \$25.00 per person per year (see question 5 above), then it is considered salary. If it is under the de minimis fringe, there are no tax implications.

- 7. *What are the tax impacts of a multi-modal commute subsidy (for example, carpool and bus)?***

This is a gray area currently not addressed by the IRS. Under a conservative interpretation, carpool benefits would be taxable. Therefore, the costs of the carpool benefits must be subtracted from the overall cost of the commute subsidy for tax purposes. The safest course of action would be to separate the value of the carpool benefit from the package of transit subsidies—for example, by providing it as an add-on. This would clearly define its value and make it easier to remove from the total value of the multi-modal subsidy.

8. *In the above case, are there Washington State tax savings for the employer?*

Contact the Washington State Department of Revenue for the status of the B&O tax credit for the current year.

9. *Can pre-tax dollars be used to encourage employees to carpool, bicycle or walk to work?*

At this point, there is no mechanism to allow pre-tax dollars to be used to provide financial incentives to employees to encourage them to use the commuting alternatives. At most, an employer can use pre-tax dollars for parking for the carpool. (Contact your tax advisor for information regarding using pre-tax dollars for carpool parking.)

Frequently asked questions about employer-provided employee parking—and the answers

The following questions are often asked regarding the tax impacts of employee parking arrangements that encourage employees to choose *an alternative to* single-occupant-vehicle (SOV) commuting. For greater detail about tax issues involving SOV parking, please consult your tax advisor.

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About parking subsidies

1. *How does the \$195 per month tax-free fringe benefit allowed by the IRS for qualified parking expenses apply to carpools?*

As of 2004, an employer can provide an employee up to \$195 per month for qualified parking expenses. This is in addition to other transportation benefits that might be offered. Carpools are treated the same as single-occupant vehicles under these regulations except that, for record keeping purposes, the parking benefit must be assigned to one employee in the carpool. If the subsidy exceeds the \$195 limit, it becomes taxable income for that individual.

- 2. *What are the tax implications of free or subsidized carpool parking where charges exist for single-occupant vehicles (SOVs)?***

There is no tax penalty if an employer chooses to subsidize carpool parking costs while not subsidizing SOV parking.

About parking “cash out”

- 3. *Where does cash out compensation appear on the W-2?***

Parking cash out is treated as additional salary. As such, it appears in box 1, 3 and 5, and is subject to all taxes. It may also be memoed on line 14.

- 4. *Are there any restrictions on how an employee can use compensation from cash out, perhaps to pay for another mode of transportation?***

The employee can use the cash out compensation in any way he or she sees fit. The compensation itself is fully taxable.

- 5. *How does one determine the value of parking if it is owned by the employer or bundled into a lease?***

The value is equal to the cost of comparable long-term parking. For example, if there is a parking lot across the street, the cost for long-term parking at that location would be a reasonable value. However, as this relates to cash out, the employer can set the value of the cash out option at any level it chooses.